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Not Cutting Tax Rates Is Boosting Deficit

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis discusses the advantages that would accrue to the economy if the federal government cut corporate taxes.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Not cutting tax rates is boosting the deficit**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

Friday, October 20, 2017

Not Cutting Tax Rates Is Boosting Deficit

It is pandering season again, with politicians and journalists wringing their hands about how cutting taxes will be a windfall to the rich and result in higher deficits. The truth, however, is that by NOT cutting taxes the federal government is losing money and the economy is suffering from sluggish growth.

Cutting taxes would almost surely result in a significant boost in revenues and stronger growth. How do I know this? Since early last year (February 2016, to be exact), when talk of tax cuts began to spread and politicians on both sides of the aisle began to agree that our corporate tax rate—the highest in the developed world—should be cut, *revenues from corporate and individual income taxes have flat-lined,* despite the fact that personal incomes have increased by almost 5%, trailing earnings per share have increased 8%, and the stock market has jumped some 30%.

It is amazing: rising incomes, rising profits, and soaring asset prices have resulted in *no increase* in revenues to the federal government, even though tax rates were not cut.

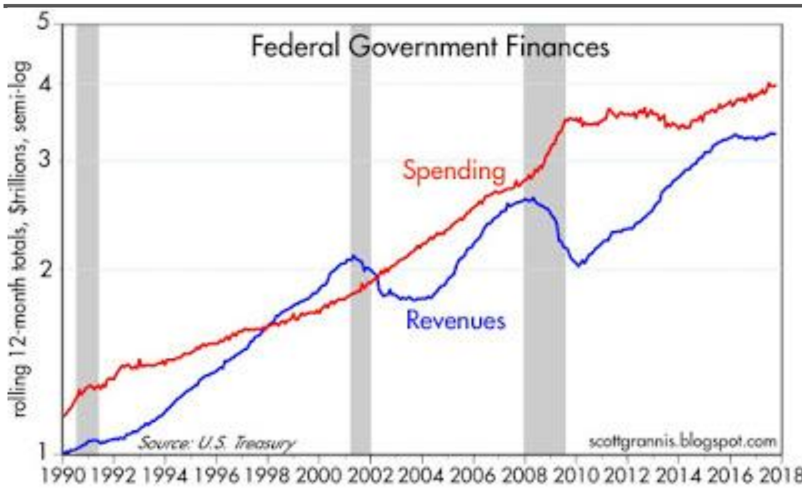
How could that possibly happen? Simple: people are rational, and they respond to incentives. Given the incentive that tax rates may be reduced in the future, individuals and corporations have apparently taken steps to reduce their current tax liabilities by delaying income, accelerating deductions, postponing investments, and postponing the realization of profits.

Consider these simple facts: S&P 500 trading volume has plunged over 40% since early last year. One reason stocks are up is that people are increasingly reluctant to sell; on the margin they would rather postpone the realization of their gains in order to minimize their current income tax liability.

I can assure you that that has been a powerful motivator for me, and I will wager that there are millions of investors who would agree.

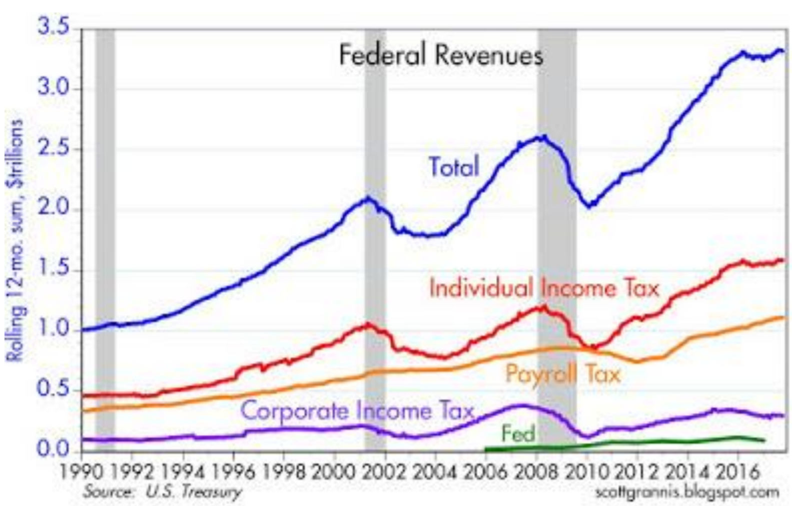
It is no wonder that NYSE member firms report a 25% increase in margin balances since February 2016 (from $436 billion to $551 billion) after no increase over the previous two years. Need income but don't want to pay capital gains taxes? Just don't sell anything and, instead, add to your margin balance.

Here are some charts which fill out the story:



The chart above shows the rolling 12-month totals of federal spending and federal revenues. Spending has been increasing steadily for the past several years, roughly in line with the growth of the economy. Revenues, however, stopped growing early last year. As a result, the 12-month deficit has increased from $405 billion in February 2016 to $665 billion in September 2017. That is a whopping increase of over 60%!

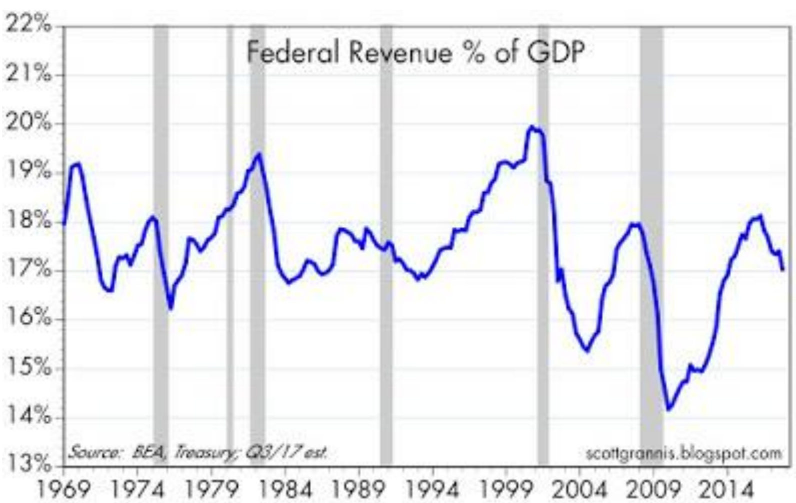
The chart below shows the major sources of federal revenues (it excludes things such as excise and customs taxes, and miscellaneous revenues, all of which are down somewhat). The only revenue category that has been increasing steadily for the past few years is Payroll Taxes (i.e., income tax withholding), by about 5% per year. That is very much in line with the growth of wages and salaries, which have been increasing at a 3.8% annual rate since February 2016.



The thing that is unique with payroll taxes is that individuals don't have much discretion over their reported income. If their salary goes up, their withholding is going to go up as well. But, individual income taxes are different. They are impacted by deductions, which can be shifted in time, as well as capital gains taxes, which can be legally postponed indefinitely, simply by not selling an appreciated asset. The rich can employ a variety of strategies to postpone or defer their income.

As it turns out, revenues from individual income taxes have experienced zero growth since February 2016, despite ongoing growth in personal income and sharply rising stock prices. Corporate income tax revenues have actually declined by about 10% since February 2016, despite an 8% rise in trailing, after-tax EPS over the same period. If you were the head of a large corporation and you thought there was a good chance of a meaningful cut in corporate income taxes, wouldn't you take all available steps to postpone income and accelerate deductions? Is it any wonder that U.S. corporations have refused to repatriate trillions of overseas profits?

So, despite ongoing growth in the economy and in incomes, plus surging stock prices, federal revenues have declined by about 1% of GDP since early last year, as the chart below shows. A static model would have projected a significant increase in revenues. No one (especially the OMB, which is still enamored of static forecasting models) expected federal revenues to be flat over the past 18-19 months. But that is what happened.



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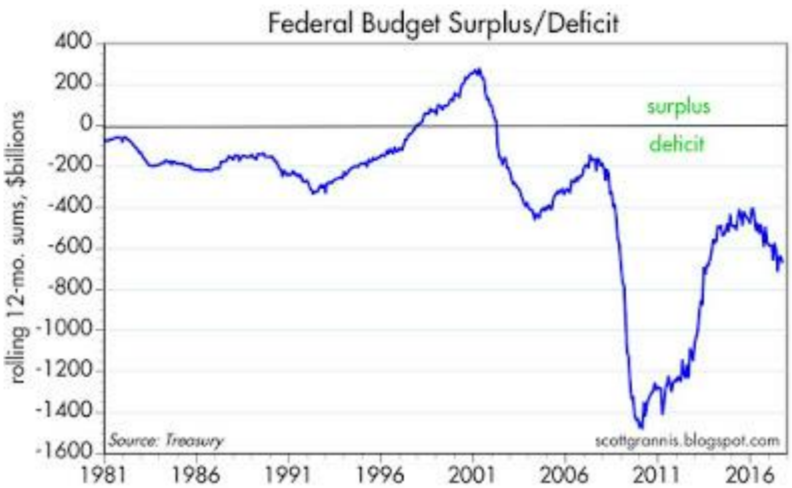
As the next chart shows, the rolling 12-month federal budget deficit has increased from $405 billion in February 2016 to $666 billion in September 2017. Relative to GDP, the federal deficit has increased from 2.4% to 3.4%. *And it is ALL due to zero growth in tax receipts*, which occurred despite no reduction in tax rates and sizable increases in incomes and capital gains.



It is only reasonable to conclude that the reason federal revenues have failed to materialize as would have been expected is that people and corporations have taken meaningful steps to postpone income, accelerate deductions, and postpone the realization of capital gains. And they have done all that because they have been thinking there was a decent chance of significant tax reform.

It is a safe bet that if the tax code is reformed, and marginal tax rates on incomes, capital gains, and corporate profits are reduced, Treasury will see an almost immediate surge in revenue. Tax reform would unleash a wave of profit-taking, a surge of capital gains realizations, a massive redeployment of capital to more productive uses, more investment (reducing taxes increases the after-tax returns to investment, thus prompting more investment), more risk-taking, more work, more growth, and ultimately reduced budget deficits. I am not talking ideology, I am just talking basic common sense.

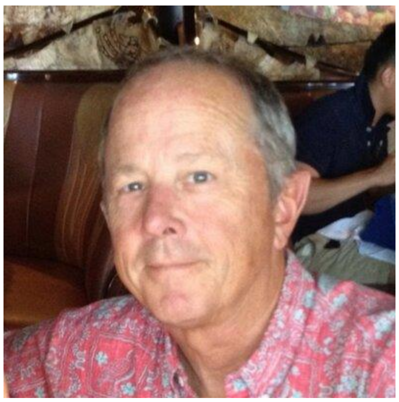
But won't the rich get the bulk of the benefit from lower tax rates? Sure, because the top 10% of income earners pay about 70% of all income taxes, and half the working population pays zero income tax. Anyway, wouldn't you rather let a rich person keep more of his money, instead of giving it to the politicians in Washington? Who do you think would spend a million dollars more productively: a rich person who is already consuming as much as he or she wants, or a politician, who would love to buy votes? When the rich keep more of their hard-earned money, they almost certainly will invest most or all of it, and that is what creates jobs and prosperity. When politicians get a windfall of revenues, they will spend it, and don't forget that over 70% of every dollar that Congress spends goes out in the form of transfer payments (i.e., money given to people who have not worked for it).

Congress needs to cut taxes in order to boost revenues and stimulate the economy. Quickly! We cannot afford to wait.

UPDATE: Art Laffer has made this same point repeatedly over the years when explaining the mistake that Reagan made in phasing in his tax cuts. If you promise that tax rates will fall in the future, you only weaken the economy today. When lower tax rates make sense, as they do today (especially corporate tax rates) rates need to be cut ASAP, otherwise capital will go dormant, awaiting the lower rates.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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